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Reducing Information Gaps to Reduce the Tax Gap: When is Information Reporting Warranted?

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Reducing Information Gaps to Reduce the Tax Gap: When is Information Reporting Warranted?

Cover Page Footnote

William W. Oliver Professor of Tax Law, Indiana University Maurer School of Law—Bloomington. I am grateful to Leslie Book, Kristen Fowler, and Joel Slemrod for helpful comments. I also benefited from helpful discussions with Hannah Buxbaum, Stephen Mazza, Susan Morse, Aviva Orenstein, Alex Raskolnikov, participants in the Closing the Tax Gap conference at Stanford Law School, and participants in the 2009 Law and Society Association Annual Meeting. Robert Christie and Michala Irons provided valuable research assistance.

ESSAY

REDUCING INFORMATION GAPS TO REDUCE THE TAX GAP: WHEN IS INFORMATION REPORTING WARRANTED?

*Leandra Lederman**

A core problem for enforcement of tax laws is asymmetric information. The taxpayer knows the facts regarding the relevant transactions it engages in during the year—or at least has ready access to that information. The government is forced to play catch-up, obtaining that information either from the taxpayer or from third parties.

Information reporting is routinely used to address this information gap. The government obtains information about the taxpayer's tax situation from a third party and—equally important—the taxpayer knows that the government has received that information. This fosters taxpayer honesty.

Information reporting is not a panacea, however. It imposes costs on the private parties who are required to report. Moreover, it will not be equally effective in all situations. Generally speaking, the effectiveness and efficiency of information reporting varies with who the reporters are, what they are reporting about, and how much information they are required to include. Accordingly, this Essay proposes six distinct factors as a framework for evaluating information reporting requirements. This Essay also applies these factors to three information reporting proposals and three recently enacted reporting requirements that are scheduled to become effective in 2011.

The proposed framework suggests that some of the laws and proposals will likely be much more effective than others in improving tax compliance. For example, the recent amendment requiring brokers to report basis in investments will likely prove very valuable, as would the proposed elimination of the reporting exemption for payments for services provided by certain small corporations. Other information reporting laws and proposals have less promise. For example, the new requirement for

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information reporting by online auction sites such as eBay regarding the gross receipts of their high-volume sellers will likely make only a minimal impact on the tax gap. Information reports in that context cannot include basis information that is known, if at all, only by the sellers. Least worthwhile are proposals that require decentralized information reporting, particularly in non-arm's-length contexts, such as requiring reporting by recipients of gifts in excess of the annual gift-tax-free limit.

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INTRODUCTION

The federal tax gap—the gap each year between taxes due and taxes paid—is enormous. The Internal Revenue Service (IRS) has estimated the gross tax gap at \$345 billion for 2001,¹ and that did not include all unpaid taxes.² To put that figure in perspective, it amounts to approximately three-fourths of the 2008 federal budget deficit and exceeds the deficits in 2005 through 2007.³ To the extent that gap can be narrowed at a cost that is low

1. See Leandra Lederman, *Statutory Speed Bumps: The Roles Third Parties Play in Tax Compliance*, 60 STAN. L. REV. 695, 711 (2007) (citing Dustin Stamper, *Everson Pledges To Narrow Growing Tax Gap*, 110 TAX NOTES 807, 807 (2006)).

2. The tax gap estimate only reflects legal-source income. See William L. Burke, *Tax Information Reporting and Compliance in the Cross-Border Context*, 27 VA. TAX REV. 399, 400 n.1 (2007). It also does not include all unreported income from international activity. See TREASURY INSPECTOR GEN. FOR TAX ADMIN., OFFICE OF INSPECTIONS AND EVALUATIONS, A COMBINATION OF LEGISLATIVE ACTIONS AND INCREASED IRS CAPABILITY AND CAPACITY ARE REQUIRED TO REDUCE THE MULTI-BILLION DOLLAR U.S. INTERNATIONAL TAX GAP (2009), <http://www.treas.gov/tigta/iereports/2009reports/2009IER001fr.html> (“Non-IRS estimates of the international tax gap range from \$40 billion to \$123 billion. While there might be overlap between the IRS tax gap estimate and the international tax gap, it is doubtful that the \$345 billion estimate includes the entire international tax gap.”).

3. See CONG. BUDGET OFFICE, MONTHLY BUDGET REVIEW 1 (2008), available at <http://www.cbo.gov/ftpdocs/99xx/doc9912/11-2008-MBR.pdf> (reporting federal budget deficit of \$455 billion for fiscal year 2008, \$162 billion for 2007, \$248 billion for 2006, and

in comparison to the additional funds collected, the government can use the funds to reduce the deficit, to lower other taxes,⁴ or to reduce debt financing of bailouts and other spending.⁵

A core problem for enforcement of tax laws is asymmetric information. One aspect of the problem is that the taxpayer knows the facts regarding the relevant transactions he or she engaged in during the tax year—or at least has ready access to that information. The government is forced to obtain that information after the fact, either from the taxpayer or from third parties.⁶

The government's direct use of that information is for enforcement. More important, however, is the indirect deterrent effect of enforcement because the magnitude of that effect is so much larger than the direct return from enforcement activities.⁷ The taxpayer's perception of the probability that cheating will be detected influences the compliance decision. Accordingly, any information that the taxpayer knows the government has about the taxpayer's activities will foster honesty.⁸ This dynamic highlights a different information asymmetry: the government knows more about its enforcement activities than taxpayers do.⁹

\$318 billion for 2005). The federal budget deficit for fiscal year 2009 was the much larger figure of \$1.4 trillion. See Jackie Calmes, *U.S. Deficit Rises to \$1.4 Trillion; Biggest Since '45*, N.Y. TIMES, Oct. 17, 2009, at A1.

4. Tax noncompliance has been estimated to cost each American taxpayer approximately \$2000 each year. See Danshera Cords, *Tax Protestors and Penalties: Ensuring Perceived Fairness and Mitigating Systemic Costs*, 2005 BYU L. REV. 1515, 1522 (citing AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, UNDERSTANDING TAX REFORM: A GUIDE TO 21ST CENTURY ALTERNATIVES 6, 29 (2005)).

5. The bailouts in 2008 included the \$700 billion Troubled Asset Relief Program and the \$200 billion bailout of Fannie Mae/Freddie Mac. See Sam Goldfarb, *House Passes TARP Reform That Would Let Treasury Buy Municipal Bonds*, 122 TAX NOTES 465, 465 (2009); David E. Libman, *Our Nation Needs a Simplified Health Savings Account System*, 121 TAX NOTES 315 (2008). In addition, as of April 2009, the government had provided to the auto industry loans and other funding totaling \$36.4 billion. U.S. GOV'T ACCOUNTABILITY OFFICE, AUTO INDUSTRY: SUMMARY OF GOVERNMENT EFFORTS AND AUTOMAKERS' RESTRUCTURING TO DATE 15 tbl.2 (2009), available at <http://www.gao.gov/new.items/d09553.pdf>.

6. See Cords, *supra* note 4, at 1543–44.

7. See, e.g., JEFFREY A. DUBIN, CRIMINAL INVESTIGATION ENFORCEMENT ACTIVITIES AND TAXPAYER NONCOMPLIANCE 21 (2004), available at <http://www.irs.gov/pub/irs-soi/04dubin.pdf> (finding, in a study of 1988–2001 IRS data, that “an additional dollar allocated to audit would return \$58 in general deterrence”); Alan H. Plumley, *The Impact of the IRS on Voluntary Tax Compliance: Preliminary Empirical Results* 8–10 (Nov. 14, 2002), reprinted in 2002 TAX NOTES TODAY 224–22 (IRS paper presented at the National Tax Association 95th Annual Conference on Taxation) (“[T]he average indirect effect of . . . audits started in 1991 was about 11.7 times as large as the average adjustment directly proposed by audits closed that year.”).

8. See Lederman, *supra* note 1, at 697 (analogizing information reporting by third parties to “red light cameras” that visibly provide information to the government about law violation).

9. For example, under Internal Revenue Code (Code) section 6103, the government is entitled to confidentiality of its audit selection procedures. See W. Edward Afield, *Agency Activism as a New Way of Life: Administrative Modification of the Internal Revenue Code Through Limited Issue Focused Examinations*, 7 FLA. TAX REV. 455, 479–80 (2006).

Information reporting is a prime example of a technique used to solve both types of information asymmetries at the prefiling stage. Withholding is well known to be highly effective in ensuring payment, but IRS data show that information reporting in the absence of withholding is almost as effective.¹⁰ With information reporting, the government obtains information about the taxpayer's tax situation from a third party and—equally important—the taxpayer knows that the government has the information.¹¹

Information reporting imposes costs on the private parties who are required to report. It is certainly not a panacea.¹² Moreover, it will not be equally effective in all situations. As discussed below, it matters who the reporters are, what they are reporting about, and how much information they include.¹³ Accordingly, this Essay proposes a series of factors that predict how efficient and effective an information reporting requirement would likely be.

The factors, in turn, facilitate evaluation of proposals that have been advanced by academics; the Treasury Department; the National Taxpayer Advocate;¹⁴ and others to require increased information reporting in various contexts, as well as several recently enacted reporting requirements.¹⁵

10. See INTERNAL REVENUE SERV., TAX YEAR 2001 TAX GAP UPDATE 2 (2007) [hereinafter TAX YEAR 2001], available at http://www.irs.gov/pub/irs-utl/tax_gap_update_070212.pdf (estimating 1.2% of amounts subject to substantial information reporting and withholding not to be reported and 4.5% of amounts subject to substantial information reporting but not withholding not to be reported); see also Joseph Bankman, *Eight Truths About Collecting Taxes from the Cash Economy*, 117 TAX NOTES 506, 511 (2007) (“By now almost everyone knows the tremendous bang for the buck we get with third-party reporting. Current rules impose relatively minor compliance costs and effectively capture most income.”).

11. See Lederman, *supra* note 1, at 697.

12. See *id.* at 698 n.10 (citing Richard M. Bird, *Administrative Dimensions of Tax Reform*, 10 ASIA-PAC. TAX BULL. 134, 136 (2004)).

13. Cf. Edward K. Cheng, *Structural Laws and the Puzzle of Regulating Behavior*, 100 NW. U. L. REV. 655, 666 (2006) (“[A] chief advantage of structural laws is that they regulate centralized institutions rather than individuals. Institutions, usually in the form of corporations, are easier to regulate because they are smaller in number, have known locations, and have significant economic incentives to comply with government mandates.”).

14. Congress established the Office of the Taxpayer Advocate, which is supervised by the National Taxpayer Advocate. I.R.C. § 7803(c)(1)(A)–(B)(i) (2006). The functions of the office are to

(i) assist taxpayers in resolving problems with the Internal Revenue Service; (ii) identify areas in which taxpayers have problems in dealings with the Internal Revenue Service; (iii) to the extent possible, propose changes in the administrative practices of the Internal Revenue Service to mitigate problems identified under clause (ii); and (iv) identify potential legislative changes which may be appropriate to mitigate such problems.

Id. § 7803(c)(2)(A). Nina Olson is the National Taxpayer Advocate. See Michael Joe et al., *Taxpayer Advocate Recommends Help for Distressed Taxpayers*, 122 TAX NOTES 185, 185 (2009).

15. This Essay does not address all recent information reporting proposals. For example, it does not address the proposal in President Barack Obama's fiscal year 2010 budget to require taxpayers who receive non-trade or business rental income and deduct related expenses to issue information reports to those who perform work costing \$600 or

Application of the factors suggests that requiring reporting by brokers of basis in securities—as Congress did as part of the Emergency Economic Stabilization Act of 2008¹⁶—should prove very valuable, as would eliminating the reporting exemption for payments to service providers organized as closely held corporations. At the other extreme, requiring decentralized information reporting, particularly in non-arm's-length contexts, such as by recipients of gifts in excess of the annual gift-tax-free limit, would be least worthwhile.

The remainder of this Essay proceeds in two principal parts. Part I considers what makes information reporting effective, setting forth a framework for evaluating information reporting proposals. The framework contains structural factors such as how much information a report would be able to provide the government relative to the type of information needed to verify that item on the taxpayer's return.

Part II of the Essay uses the proposed framework to evaluate the relative efficiency of three recent information reporting proposals and three recently enacted requirements that have not yet taken effect. It finds that some of the proposals and one of the new laws will likely help narrow the federal tax gap, while others are likely to be ineffective.

I. WHAT MAKES INFORMATION REPORTING EFFECTIVE?

"Voluntary" compliance with U.S. federal taxes—compliance without enforcement efforts on the part of the government—is sometimes said to be surprisingly high, given that audit and penalty rates are not high enough to make compliance the economically rational choice.¹⁷ However, the reality is that audits are not the only tool the government has that makes the probability of detection high and compliance rational. As is by now well known, much of the work of assuring voluntary compliance is done by third parties, through withholding of taxes on wages and salaries, as well as

more on the rental property. See DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2010 REVENUE PROPOSALS 58 (2009) [hereinafter FISCAL YEAR 2010 REVENUE PROPOSALS], available at <http://www.ustreas.gov/offices/tax-policy/library/grmbk09.pdf>. Similarly, the Essay does not address information reporting proposals addressing cross-border transfers, such as the proposal to require certain financial intermediaries to report transfers of money or property with a value of more than \$10,000 to a foreign bank, brokerage, or other financial account on behalf of a U.S. person. See *id.* at 48. However, the six factors discussed below are just as applicable to these proposals as they are to the proposals and laws discussed in detail in this Essay.

16. Pub. L. No. 110-343, 122 Stat. 3765.

17. See, e.g., James Alm, Isabel Sanchez & Ana de Juan, *Economic and Noneconomic Factors in Tax Compliance*, 48 KYKLOS 3, 3 (1995) ("[T]he puzzle of tax compliance is not so much 'Why is there so much cheating?['] Instead, the real puzzle is 'Why is there so little cheating?'""); Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 VA. L. REV. 1781, 1782 (2000) ("A widespread view among tax scholars holds that law enforcement does not explain why people pay taxes."). But cf. Leandra Lederman, *Tax Compliance and the Reformed IRS*, 51 U. KAN. L. REV. 971, 974–76 (2003) (rebutting this view).

information reporting regarding those payments and others, such as interest; dividends; and payments to independent contractors.¹⁸

The IRS's study of the 2001 tax year, under the auspices of its National Research Program, reveals that information reporting makes the single biggest difference in compliance rates—approximately forty-five percentage points:

Amounts subject to withholding (*e.g.*, wages and salaries) have a net misreporting percentage of only 1.2 percent. Amounts subject to third-party information reporting, but not to withholding (*e.g.*, interest and dividend income) have a slightly higher net misreporting percentage of 4.5 percent. Amounts subject to partial third-party reporting (*e.g.*, capital gains) have a still higher net misreporting percentage of 8.6 percent. Amounts not subject to withholding or information reporting (*e.g.*, Schedule C income and "other income") are the least visible, with a much higher net misreporting percentage of 53.9 percent.¹⁹

It is no coincidence that information reporting is so effective. The government suffers from an information asymmetry in enforcing the tax laws because taxpayers are the ones who know the facts regarding their activities in the first instance. The IRS therefore has to learn that information after the fact, either from those taxpayers or from third parties. Information reporting by third parties as to particular amounts the taxpayer received for a particular reason reduces that information gap. However, if information reports were sent by the third party only to the federal government, they likely would not have such a dramatic effect on voluntary compliance. Instead, that reporting would simply empower the government with a tool to use on audit.²⁰ What likely makes information reporting so

18. See Lederman, *supra* note 1, at 697 & nn.7–8. Thus, the comparison between comparatively high compliance rates and low audit rates ignores the fact that information reporting—transparency, which increases the probability of detection—accounts for much of the overall (average) voluntary compliance rate of approximately eighty-four percent. See *id.* at 697; Lederman, *supra* note 17, at 974; Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 OHIO ST. L.J. 1453, 1460 (2003).

19. Charles P. Rettig, *Nonfilers Beware: Who's That Knocking at Your Door?*, J. TAX PRAC. & PROC., Oct.–Nov. 2006, at 19, 19–20; see also TAX YEAR 2001, *supra* note 10, at 2.

20. The IRS apparently makes good use of information reports, though it does not pursue nearly all discrepancies:

According to IRS, after correction, about 98 percent of the information returns it receives are potentially usable for matching purposes

After going through the matching process, IRS pursues millions of discrepancies above certain dollar thresholds; according to IRS officials, millions of other discrepancies above the thresholds are not pursued because of resource constraints.

U.S. GOV'T ACCOUNTABILITY OFFICE, TAX ADMINISTRATION: COSTS AND USES OF THIRD-PARTY INFORMATION RETURNS 11 (2007) [hereinafter, GAO, COSTS AND USES], available at <http://www.gao.gov/new.items/d08266.pdf>. As the quotation above suggests, the IRS does not pursue discrepancies below a certain dollar threshold. *Id.* app. I, at 60. Of those above the threshold, for tax years 2003 through 2005, the IRS pursued twenty-eight to thirty-one percent of the discrepancies in underreporting cases and thirty-five to fifty-nine percent in nonfiling cases. See *id.* app. I, at 61.

successful in spurring compliance in the first instance is that, like “red light cameras” that snap pictures of vehicles failing to stop for a red light, the taxpayer is aware that the government is watching.²¹

Information reporting is certainly a valuable tool in the government’s enforcement arsenal, and it has not gone unnoticed by scholars and policy makers.²² In fact, if anything, it has been recommended for too broad an array of contexts. In some situations, the costs of information reporting would outweigh the benefits.²³ In evaluating proposals to expand the scope of information reporting, it is therefore helpful to identify the context in which it is successful. In general, the following six factors are relevant:

(1) *Arm’s-length parties*. Because the government will use an information report to verify that the taxpayer has reported the same information on his or her return, information reporting is of most use where the possibility of collusion is relatively small. This suggests that contexts involving parties who generally act at arm’s length (such as service recipient and service provider) are more suitable for information reporting than are contexts involving related parties (such as family members).²⁴ In addition, the possibility of collusion to avoid or falsify information reporting is reduced where the reporting party obtains a tax benefit that increases with the amount reported, as in the case of a non-tax-exempt employer reporting wages on a Form W-2.²⁵

Nina Olson has proposed accelerating the IRS’s processing of information returns so that it would send out fewer refunds before processing those returns. See NAT’L TAXPAYER ADVOCATE, REPORT TO CONGRESS: FISCAL YEAR 2010 OBJECTIVES xxii (2009), available at http://www.irs.gov/pub/irs-utl/fy2010_objectivesreport.pdf. She explains that this would help reduce fraud as well as reduce the burden on taxpayers eligible for refundable credits whose claims might otherwise be frozen. *Id.* at xix–xxii.

21. See Lederman, *supra* note 1, at 697 & n.9.

22. See, e.g., U.S. GOV’T ACCOUNTABILITY OFFICE, TAX COMPLIANCE: MULTIPLE APPROACHES ARE NEEDED TO REDUCE THE TAX GAP 12 (2007) (“Information reporting tends to lead to high levels of compliance because income taxpayers earn is transparent to them and IRS.”); Cords, *supra* note 4, at 1544 (“Mandatory withholding and third-party information reporting eliminate the opportunity for most taxpayers to underreport their income without detection.”); Lederman, *supra* note 1, at 698 (“Information reporting and withholding extend to a variety of types of income in the U.S.[.], and are highly successful at securing compliance.”).

23. OFFICE OF MGMT. & BUDGET, EXECUTIVE OFFICE OF THE PRESIDENT, ANALYTICAL PERSPECTIVES: BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2008, at 194–95 (2007), available at <http://www.whitehouse.gov/omb/budget/fy2008/pdf/spec.pdf> (“[Information reporting] is not possible in all cases and even where it is possible it might require burdensome new reporting requirements for individuals and businesses. For example, individuals paying a contractor or purchasing a car might be required to file reports to the IRS reporting these transactions. Such broad expansions of reporting requirements would be excessively burdensome, and . . . this consideration outweighs the gains they might bring in increased compliance.”).

24. Cf. Lederman, *supra* note 1, at 725–26 (contrasting arm’s-length relationships with typical family relationships).

25. See *id.* at 729–30. In theory, the employer could report lower wages on Form W-2 than on its tax return, but that would increase the risk of detection via matching of the related returns.

(2) *Bookkeeping infrastructure.* Information reporting is more efficient when required of taxpayers, such as businesses, with a bookkeeping infrastructure than when required of individuals without such an infrastructure.²⁶

(3) *Centralization.* Information reporting is more efficient when required of parties who are fewer in number than the recipients of the reports, making auditing more centralized²⁷ (assuming compliance with information reporting is reviewed on audit,²⁸ as it should be). Often, this goes hand-in-hand with item (2) (*Bookkeeping infrastructure*); businesses tend to be fewer in number than their customers or employees.²⁹

(4) *Complete reporting.* Information reporting is most effective when it provides all of the information necessary for the government to match the third-party report with corresponding amounts on the taxpayer's return; partial reporting reduces enforcement efficiency.³⁰ For example, Form W-2 provides wage and salary information that the IRS can directly match by computer with an employee's return. If an employee worked for multiple employers during the year, the IRS must aggregate the amounts on the Forms W-2, but it will still have all of the information necessary to perform the matching.³¹

(5) *Few alternative arrangements.* To the extent the taxpayer has fewer ways to cheaply avoid an information reporting requirement, it will be more effective and result in fewer distortions. For example, if an employer could avoid information reporting requirements by reclassifying employees as independent

26. Cf. Kyle D. Logue & Joel Slemrod, *Of Coase, Calabresi, and Optimal Tax Liability* 1, 34 (Univ. of Mich. Law & Econ., Working Paper No. 09-004, 2009), available at <http://ssrn.com/abstract=1335924> (explaining that economies of scale suggest that tax compliance costs are lower for larger tax remitters). Code section 6041, for example, provides that "[a]ll persons engaged in a trade or business" who make certain payments aggregating \$600 or more to one recipient must issue an information return. I.R.C. § 6041(a) (2006).

27. See Cheng, *supra* note 13, at 666 (pointing out the advantage of "regulat[ing] centralized institutions rather than individuals"); Logue & Slemrod, *supra* note 26, at 34 ("Economies of scale to learning the tax laws, to gathering the relevant tax information, and to filing forms with the tax authorities, would suggest that bigger is better: that larger taxpayers would present lower compliance costs per unit of tax remitted and collected.").

28. See Bankman, *supra* note 10, at 512 ("[M]any auditors do not enforce the current reporting requirements. One reason for this is that auditors naturally focus on whether a particular taxpayer has paid all of its tax liabilities. Looking to see whether a taxpayer has met its reporting obligations is not an audit priority.").

29. Cf. Cheng, *supra* note 13, at 666 ("Institutions, usually in the form of corporations, are easier to regulate because they are smaller in number, have known locations, and have significant economic incentives to comply with government mandates.").

30. Cf. Bankman, *supra* note 10, at 512 ("It is not so easy to make use of 1099's in business, where 1099's account for only a fraction of gross sales. A simple computer check will not reveal whether income has been underreported.").

31. In other words, the IRS will have sufficient information to check that the amount reported as wages at least equals the total amounts reported on Forms W-2.

contractors (which it cannot under current law),³² that would increase the employer's incentive both to claim that workers are independent contractors and to restructure working conditions so that workers fall within the independent contractor classification.

(6) *Contributor to tax gap.* Information reporting is not efficient if the amount at stake is not substantial enough to justify the cost of information return issuance by payors and processing by the IRS. Thus, transactions of a type that do not contribute much to the tax gap in the absence of information reporting are not prime targets for information reporting.

These structural principles allow systematic evaluation of three recently adopted information reporting requirements that have not yet become effective and of three proposals to extend information reporting to contexts in which it is not currently required. After discussing the recently enacted requirement that brokers report basis in securities transactions, the following proposals and new laws are considered below: eliminating the reporting exemption for electing small business corporations (S corporations) and other closely held corporations with respect to payments by businesses to service providers;³³ requiring online auction sites, such as eBay, to provide information reports to sellers;³⁴ requiring information reporting on consumer purchases, either by consumers or financial intermediaries;³⁵ and requiring information reporting by recipients

32. Under current law, an information reporting requirement will still apply (assuming the dollar threshold is met). See I.R.C. § 6041A(a) (2006). However, an employer can avoid withholding taxes if it successfully classifies the workers as independent contractors. See *id.* §§ 3306, 3402; Treas. Reg. § 31.3306(i)-1 (1960).

33. See Bankman, *supra* note 10, at 511–12 (referring to “chang[ing] the reporting rules to include S corporations and closely held corporations”); see also *Hearing on the Tax Gap Before the Subcomm. on Taxation and IRS Oversight of the S. Comm. on Finance*, 109th Cong. 14 (2006) (statement of Nina E. Olson, National Taxpayer Advocate) [hereinafter *Hearing on the Tax Gap*], available at http://www.irs.gov/pub/irs-utl/ntatestimonysfctax_gap072606.pdf; Joseph Bankman, *Tax Enforcement: Tax Shelters, the Cash Economy, and Compliance Costs*, 104 TAX NOTES 185, 189 (2004) (“[W]e might apply the reporting requirements to payments to S corporations as well as partnerships.”).

34. As discussed below, Congress recently enacted an information reporting requirement applicable to high-volume sellers. Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, § 3091(e)(1), 122 Stat. 2654, 2911 (to be codified at I.R.C. § 3406 note). Section 6050W, which also contains requirements related to payment card transactions, is scheduled to apply to “calendar years beginning after December 31, 2010.” I.R.C. § 6050W (West Supp. 2009).

35. See, e.g., Joshua D. Rosenberg, *Narrowing the Tax Gap: Behavioral Options*, 117 TAX NOTES 517, 523–24 (2007) (proposing information reporting by consumers and financial institutions); see also DEP’T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2008 REVENUE PROPOSALS 66 (2007) [hereinafter GENERAL EXPLANATIONS], available at <http://www.treas.gov/offices/tax-policy/library/bluebk07.pdf>; 1 TAXPAYER ADVOCATE SERV., 2007 ANNUAL REPORT TO CONGRESS 500–01 (2007) [hereinafter TAXPAYER ADVOCATE SERV., 2007 ANNUAL REPORT], available at http://www.irs.gov/pub/irs-utl/arc_2007_vol_1_legislativerec.pdf. Section II.D.2 of this Essay also discusses a recently enacted provision applicable in the payment card context. See I.R.C. § 6050W(a), (b)(1)(A).

of gifts in excess of the annual gift tax exclusion.³⁶ The most promising areas for information reporting are discussed first.

II. EVALUATING INFORMATION REPORTING LAWS AND PROPOSALS

A. Basis Reporting in Securities Transactions

In the Emergency Economic Stabilization Act of 2008 (the Act),³⁷ Congress required brokers to report basis in securities.³⁸ The Act amends Internal Revenue Code (Code) section 6045 to require brokers who are already required to file information returns to “include the customer’s adjusted basis in such security and whether any gain or loss with respect to such security is long-term or short-term (within the meaning of section 1222).”³⁹ The amendment is scheduled to apply to securities acquired on or after January 1, 2011, at the earliest.⁴⁰ A change along these lines had previously been proposed by scholars and policy makers.⁴¹

36. See Mitchell M. Gans & Jay A. Soled, *Reforming the Gift Tax and Making It Enforceable*, 87 B.U. L. REV. 759, 792–93 (2007).

37. Pub. L. No. 110-343, 122 Stat. 3765.

38. Economic Stabilization Act of 2008 § 403, I.R.C. § 6045(g).

39. *Id.* § 403(a)(1), I.R.C. § 6045(g)(2). Code section 1222 defines long-term and short-term capital gain. See I.R.C. § 1222(1), (3) (2006). Failure to comply with the information reporting requirements will be subject to penalties. The Preamble to proposed regulations issued in December 2009 explains,

The Act amended the list of returns and statements in section 6724(d) for which sections 6721 and 6722 impose penalties for any failure to file or furnish complete and correct returns and statements. This section imposes a penalty on brokers for a failure to file returns or furnish complete and correct statements after a sale of securities as required by section 6045. Section 6724(d) now also imposes penalties with respect to the returns and statements required by sections 6045A and 6045B.

Information Reporting for Payments Made in Settlement of Payment Card and Third Party Network Transactions, 74 Fed. Reg. 67,010, 67,012 (Dec. 17, 2009) [hereinafter December 2009 Notice of Proposed Rulemaking], *reprinted in* 2009 TAX NOTES TODAY 240-14.

40. See I.R.C. § 6045(g)(2) (applying reporting of basis information in a “covered security”); *id.* § 6045(g)(3)(A) (defining “covered security” as “any specified security acquired on or after the applicable date” if certain requirements are met); *id.* § 6045(g)(3)(C) (providing applicable dates of January 1, 2011, for most stock; January 1, 2012, for certain stock; and “January 1, 2013, or such later date determined by the Secretary in the case of any other specified security”). The Preamble to the proposed Treasury regulations explains,

For stock in a RIC [Regulated Investment Company] . . . or stock acquired in connection with a DRP [Dividend Reinvestment Plan] . . . section 6045(g)(3)(C)(ii) provides that the applicable date is January 1, 2012. For any other specified security, section 6045(g)(3)(C)(iii) provides that the applicable date is January 1, 2013, or a later date determined by the Secretary. The reporting rules related to options transactions apply only to options granted or acquired on or after January 1, 2013, as provided in section 6045(h)(3).

December 2009 Notice of Proposed Rulemaking, *supra* note 39, at 67,011.

41. See GENERAL EXPLANATIONS, *supra* note 35, at 64; 1 TAXPAYER ADVOCATE SERV., 2005 ANNUAL REPORT TO CONGRESS 437 (2005), available at http://www.irs.gov/pub/irs-utl/section_2.pdf; Joseph M. Dodge & Jay A. Soled, *Debunking the Basis Myth Under the Income Tax*, 81 IND. L.J. 539, 582–97 (2006) [hereinafter Dodge & Soled, *Debunking the*

Brokers already were required to produce information reports containing the sales price of a security, and, in addition, they often had the purchase price information because they served as the broker on the purchase.⁴² Thus, the new law generally will enable information reporting on securities sales to move from partial reporting to more comprehensive reporting, in line with item (4) (*Complete reporting*), above.⁴³ The cost to brokers of adding that item should be relatively small, given that many of them tracked gains and losses anyway,⁴⁴ and they were already required to make information reports. Brokers typically act at arm's length with their customers, they are businesses, and they are fewer in number and generally more sophisticated in the relevant calculations than their customers.⁴⁵ Moreover, noncompliance by taxpayers on their securities transactions was alleged to be substantial.⁴⁶ Accordingly, this change will likely prove to be

Basis Myth]; Joseph M. Dodge & Jay A. Soled, *Reporting Tax Basis: Dawn of a New Era*, 110 TAX NOTES 784, 784 (2006).

42. Dodge & Soled, *Debunking the Basis Myth*, *supra* note 41, at 584. When it enacted the basis reporting requirement, Congress also added Code section 6045A. *See* Pub. L. No. 110-343, § 403(c)(1), 122 Stat. at 3858. That section requires

[e]very applicable person which transfers to a broker (as defined in section 6045(c)(1)) a security which is a covered security (as defined in section 6045(g)(3)) in the hands of such applicable person [to] furnish to such broker a written statement . . . for purposes of enabling such broker to meet the requirements of section 6045(g).

I.R.C. § 6045A(a). By statute, a broker is an "applicable person." *Id.* § 6045A(b)(1). Proposed regulations issued in December 2009 provide that the term applicable person also includes "any person that acts as a custodian of securities in the ordinary course of a trade or business, any issuer of securities, and any agent of these persons." Prop. Treas. Reg. § 1.6045A-1(a)(3), 74 Fed. Reg. 67,010, 67,021 (Dec. 17, 2009) (to be codified at 26 C.F.R. pt. 1). These provisions are designed to limit the ability of a taxpayer subject to the reporting requirement to avoid the requirement by having securities transferred to another broker.

43. *See supra* note 30 and accompanying text.

44. Dodge & Soled, *Debunking the Basis Myth*, *supra* note 41, at 584–85.

45. J. COMM. ON TAXATION, 110TH CONG., DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2009 BUDGET PROPOSAL 145 (Comm. Print 2008) [hereinafter J. COMM. ON TAXATION, 2009 BUDGET PROPOSAL], *available at* <http://www.house.gov/jct/s-1-08.pdf>.

46. The Treasury Department estimated that the proposed change would raise \$6.7 billion from 2008 through 2017. GENERAL EXPLANATIONS, *supra* note 35, at 64; *cf. The Causes of and Solutions to the Federal Tax Gap Before the S. Comm. on the Budget*, 109th Cong. 4–5 (2006) (statement of Nina E. Olson, National Taxpayer Advocate) [hereinafter *Causes and Solutions*], *available at* http://budget.senate.gov/democratic/testimony/2006/olsen_taxgap021506.pdf ("Reliable estimates of the amount of underreporting in this area are difficult to come by, but two professors have sized the problem at about \$25 billion a year. IRS officials studying the NRP data believe the revenue loss is substantially lower, but they agree that the level of underreporting reaches into the billions of dollars." (citing Joseph M. Dodge & Jay A. Soled, *Inflated Tax Basis and the Quarter-Trillion-Dollar Revenue Question*, 106 TAX NOTES 453 (2005))). Nina Olson noted that "Treasury's proposal would not take effect until 2009, and it would only require basis reporting with regard to securities purchased after that date. In the early years, many securities sold would have been purchased prior to the effective date of the proposal and thus would be exempt from reporting." *The IRS and the Tax Gap Before the H. Comm. on the Budget*, 110th Cong. 5 n.10 (2007) (statement of Nina E. Olson, National Taxpayer Advocate) [hereinafter *The*

a valuable one. It also has the benefit of being helpful to honest taxpayers by reducing the burden of tracking basis information.⁴⁷

A conceivable drawback of the new provision is the possibility of investor migration away from securities for which basis reporting is required and into investments where basis reporting is not required.⁴⁸ Treasury regulations that maintain the applicability of the requirement to a broad set of securities will limit the ability of taxpayers to shift to substantially similar, but less transparent, investments.⁴⁹

B. Eliminating Exceptions for Payments for Services Provided by Small Corporations

Just as employers must issue information reports with respect to their employees (on Form W-2), those who use the services of independent contractors generally must issue reports with respect to those service

IRS and the Tax Gap], available at http://www.irs.gov/pub/irs-utl/nta_housebudget_testimony_021607.pdf.

47. See Dodge & Soled, *Debunking the Basis Myth*, *supra* note 41, at 584 (“A gain and loss reporting system would make things easier for taxpayers, who would not have to keep track of basis at all in the case of financial assets acquired and housed with a broker.”). Nina Olson explains,

To illustrate, a taxpayer who has held AT&T stock since the 1980s has received shares in more than a dozen companies over the years, and on each such occasion, the taxpayer’s cost basis had to be split between his existing holding and the spun-off company. Similarly, most mutual fund customers elect to have dividend and capital gain distributions automatically reinvested, and the customer’s aggregate basis in a mutual fund holding changes upon each such distribution. If taxpayers don’t have complete records, they will be unable to determine or substantiate their basis in many instances. We recommended requiring brokers to track and report cost basis primarily because it would make life much easier for honest taxpayers.

Causes and Solutions, *supra* note 46, at 5.

48. J. COMM. ON TAXATION, 2009 BUDGET PROPOSAL, *supra* note 45, at 145.

49. See *id.* (“[T]he likelihood of distortions will depend in part on the breadth of the rules ultimately provided in Treasury regulations defining the types of securities that are subject to the proposal.”). The legislation applies the new provisions to the following:

- (i) any share of stock in a corporation,
- (ii) any note, bond, debenture, or other evidence of indebtedness,
- (iii) any commodity, or contract or derivative with respect to such commodity, if the Secretary determines that adjusted basis reporting is appropriate for purposes of this subsection, and
- (iv) any other financial instrument with respect to which the Secretary determines that adjusted basis reporting is appropriate for purposes of this subsection.

I.R.C. § 6045(g)(3)(B) (West Supp. 2009) (effective Jan. 1, 2011, Jan. 1, 2012, and Jan. 1, 2013). Proposed regulations issued in December 2009 apply the reporting requirement to any “specified security” acquired in a sale transaction or for which the broker received a transfer statement stating that the security is subject to the reporting requirements; “[s]tock in a regulated investment company if acquired through a sale transaction in an account on or after January 1, 2012”; and “[s]tock acquired in connection with a dividend reinvestment plan if acquired through a sale transaction in an account on or after January 1, 2012.” Prop. Treas. Reg. § 1.6045-1(a)(15)(ii)–(iii), 74 Fed. Reg. 67,010, 67,030 (Dec. 17, 2009) (to be codified at 26 C.F.R. pt. 1). The proposed regulations limit the term “specified security” to stock, see Prop. Treas. Reg. § 1.6045-1(a)(14), 74 Fed. Reg. at 67,030, but the Preamble states that options and debt instruments “are expected to be addressed in future guidance.” December 2009 Notice of Proposed Rulemaking, *supra* note 39, at 67,013.

providers (on Form 1099). Code section 6041A contains an information reporting requirement applicable to “any service-recipient engaged in a trade or business [who] pays in the course of such trade or business during any calendar year remuneration to any person for services performed by such person, . . . [if] the aggregate of such remuneration paid to such person during such calendar year is \$600 or more.”⁵⁰ However, the Treasury Department has long exempted by regulation⁵¹ most domestic and foreign corporate payees.⁵² The scope of the exemption includes both electing small business corporations (S corporations) and other corporations (C corporations).⁵³

The exclusion raises compliance concerns for two connected reasons. First, it eliminates information reporting for amounts received by corporate payees, including small ones. Small businesses are the largest contributors to the tax gap.⁵⁴ Second, incorporation is available as a strategic option for small businesses.⁵⁵ Individuals inclined to evade taxes may therefore form a wholly owned corporation simply to avoid receiving information reports.⁵⁶

50. I.R.C. § 6041A(a)(1)–(2) (2006).

51. Cf. TAXPAYER ADVOCATE SERV., 2007 ANNUAL REPORT, *supra* note 35, at 495 n.26 (“Although the corporate exception could be changed by regulation, because it has been in place for many years during which Congress has made changes to the information reporting rules, the Treasury Department believes the corporate exception should be eliminated through legislation.” (citing GENERAL EXPLANATIONS, *supra* note 35, at 63)).

52. See Treas. Reg. § 1.6041-3 (as amended in 2000) (“Returns of information are not required under section 6041 and §§ 1.6041-1 and 1.6041-2 for payments described in paragraphs (a) through (q) of this section.”); *id.* § 1.6041-3(p)(1) (as amended in 2006) (“[a] corporation described in § 1.6049-4(c)(1)(ii)(A),” subject to limited exceptions); *id.* § 1.6049-4(c)(1)(ii)(A) (as amended in 2006) (“A corporation, as defined in section 7701(a)(3), whether domestic or foreign, is an exempt recipient.”). Note that under Code section 6041A(d)(3), notwithstanding the regulations, information reporting does apply to payments to corporations made by federal executive agencies.

53. See I.R.C. § 7701(a)(3) (defining “[t]he term ‘corporation’ [to] include[] associations, joint-stock companies, and insurance companies” and not distinguishing between S corporations and C corporations); see also *id.* § 1361(a) (defining both C and S corporations as types of corporations).

54. See generally TAX YEAR 2001, *supra* note 10; see also TAXPAYER ADVOCATE SERV., 2007 ANNUAL REPORT, *supra* note 35, at 490 & n.4 (“Although the IRS does not estimate the portion of the tax gap attributable to the so called ‘cash economy,’ unreported income from the cash economy is probably the single largest component of the tax gap, likely accounting for over \$100 billion per year.”). Some countries use withholding by payors or “reverse withholding” systems (withholding by payees) to promote tax compliance by small businesses. See Piroška Soos, *Self-Employed Evasion and Tax Withholding: A Comparative Study and Analysis of the Issues*, 24 U.C. DAVIS L. REV. 107, 131, 143–45 (1990). These systems are beyond the scope of this Essay.

55. IRS Official’s Testimony at House Hearing on Employment Taxes: Hearing Before the Subcomm. on Commerce, Consumer, and Monetary Affairs of the H. Comm. on Government Operations, 103d Cong. (1993) (statement of Marshall V. Washburn, Compliance 2000 Executive, I.R.S.), reprinted in 93 TAX NOTES TODAY 122-37 (“Currently payors are required to report service payments made to non-corporate entities, but not those made to corporations. This exemption may be a significant reason why voluntary compliance for small corporations is low.”).

56. See *id.* (“There are indications that some independent contractors incorporate or claim to be incorporated to avoid information reporting.”); cf. *The IRS and the Tax Gap*,

Nina Olson, the National Taxpayer Advocate, has explained,

One possible justification for the corporate exception to the information reporting requirements is that large corporations are less likely to underreport income than sole proprietors because they must account to unrelated shareholders for business earnings and expenses. The same reports and accounting systems used to account to shareholders can be audited by the IRS, reducing the temptation to understate income. However, these safeguards may not be present in many closely-held corporations.⁵⁷

In addition, the corporate exception requires payors to determine whether the payee is an individual or a corporation, which adds some compliance cost.⁵⁸

Several tax experts, including Olson and Professor Joseph Bankman, have proposed eliminating this exception.⁵⁹ Estimates of the revenue that could be raised by this proposal over a ten-year period range from \$6.8 billion to \$7.7 billion.⁶⁰

The principal drawback of this proposal is its compliance cost for payors. An advocate for small businesses explained that some business might be new to the Form 1099 filing system, and those already filing 1099 Forms would face increased burdens.⁶¹ However, a recent Government

supra note 46, at 5 (statement of Nina E. Olson) (“There are, of course, many valid reasons for choosing to conduct business as a corporation, but information-reporting avoidance should not be such a reason.”).

57. TAXPAYER ADVOCATE SERV., 2007 ANNUAL REPORT, *supra* note 35, at 495.

58. J. COMM. ON TAXATION, 2009 BUDGET PROPOSAL, *supra* note 45, at 141.

59. *See Hearing on the Tax Gap*, *supra* note 33, at 14 (statement of Nina E. Olson) (“For Form 1099-MISC information reporting purposes, I believe there should be no distinction between taxpayers providing the same services for compensation merely because one taxpayer has incorporated and another has not.”); TAXPAYER ADVOCATE SERV., 2007 ANNUAL REPORT, *supra* note 35, at 495 (recommending that “[i]f the IRS’s National Research Program (NRP) shows significant levels of noncompliance among small corporations, [Congress should] reiterate and clarify the IRS’s authority to require third-party information reporting for applicable payments (aggregating to \$600 or more) to independent contractors who are operating as corporations”); Bankman, *supra* note 10, at 511 (referring to “chang[ing] the reporting rules to include S corporations and closely held corporations”); Bankman, *supra* note 33, at 189; *see also* Taxpayer Responsibility, Accountability, and Consistency Act of 2008, H.R. 5804, 110th Cong. § 2 (2008); Jay A. Soled, *Homage to Information Returns*, 27 VA. TAX REV. 371, 385 (2007) (“Under current law, recipients of paid-for services must issue information returns . . . to individual service providers if the aggregate value of such services for any calendar year exceeds \$600. This same requirement does not apply if the service provider in question is a corporate entity. On its face, this appears to be a silly distinction.” (citing I.R.C. § 6041A(a); Treas. Reg. §§ 1.6041-3(p)(1), 1.6049-4(c)(1)(ii)(A) (as amended in 2006))).

60. *See* J. COMM. ON TAXATION, 2009 BUDGET PROPOSAL, *supra* note 45, at 313 (estimating \$6.8 billion for 2008–2018, with 2008 treated as before the effective date and estimated at zero); GENERAL EXPLANATIONS, *supra* note 35, at 63.

61. *Closing the Tax Gap Without Creating Burdens for Small Businesses: Hearing Before the H. Small Business Comm.*, 110th Cong. 3 (2007) (statement of Paul Hense, Hense and Associates, on Behalf of the National Small Business Association) [hereinafter *Closing the Tax Gap*], available at http://www.nsba.biz/docs/hense_testimony_4-25-07_final.pdf.

Accountability Office study suggests that the cost to small businesses of producing information returns is low:

In our nine case studies, filers of information returns told us that existing information return costs, both in-house and for external payments, were relatively low. . . . One small business employing under five people told us of possibly spending 3 to 5 hours per year filing Form 1099 information returns manually, using an accounting package to gather the information. . . . Two external parties reported prices for preparing and filing Forms 1099 with IRS of about \$10 per form for 5 forms to about \$2 per form for 100 forms, with one of them charging about \$.80 per form for 100,000 forms.⁶²

It is also theoretically possible to exempt from the requirement payments by certain payors (such as the smallest ones) or to certain payees (such as very large corporations, which are already highly regulated).⁶³ Accordingly, the National Taxpayer Advocate has proposed,

Congress should direct the IRS to waive the requirement for those corporations willing to certify they have had a large number of shareholders (e.g., 50 or more shareholders), at any time in the prior calendar year (or prior 12-month period). IRS Form W-9 could be revised to include a check box for the corporation to indicate if it had the requisite number shareholders at any time in the prior calendar year (or prior 12-month period).⁶⁴

The waiver proposal may reflect the fact that an outright exemption can add complexity and gaming opportunities.

This proposal is promising under the six factors developed above. It involves situations in which the parties (service recipient and service provider) generally act at arm's length. In addition, because the requirement relates to the performance of services to businesses, the payor generally would be able to deduct the payment, which reduces the possibility of collusion between payor and payee to underreport.

Furthermore, the proposal would not expand payor information reporting beyond businesses. The payors also will generally be fewer in number than the payees, with the possible exception of situations in which a small business spends substantial amounts on the services of several vendors, including large providers such as Federal Express.⁶⁵ However, a waiver for large corporate payees would address much of that issue. The proposal would also reach an important area of noncompliance—underreporting by

62. GAO, COSTS AND USES, *supra* note 20, at 3.

63. Small business advocate Paul Hense argues, “[i]n practicality, this [information reporting proposal] means that every time a small-business owner ships a package with Federal Express or uses some other service, and the expenses total more than \$600 by year-end, they would need to keep the receipts, prepare a Form 1099 and file them not only with the IRS, but with Federal Express and any other companies as well.” *Closing the Tax Gap*, *supra* note 61, at 3 (statement of Paul Hense).

64. TAXPAYER ADVOCATE SERV., 2007 ANNUAL REPORT, *supra* note 35, at 495–96.

65. See *supra* note 63 and accompanying text.

small businesses.⁶⁶ Finally, the proposal would reduce the distortion that results from incorporation undertaken to avoid information reporting.⁶⁷

As with 1099 Forms provided to individuals who perform services, a Form 1099 provided to a corporate payee would provide all of the information necessary for the government to match the report with an amount on the taxpayer's return (though, as with individuals who work for multiple payors, the IRS would have to aggregate the amounts reported). One difficulty that corporations introduce in this regard is that many of them may not be required to report the income in the same calendar year in which a 1099 is issued because they are fiscal year taxpayers and/or are on the accrual method.⁶⁸ The IRS would therefore need to consider multiple years in some cases in order to perform adequate return matching.

Nonetheless, information reporting to corporate payees holds promise. It should have some deterrent effect and reduce strategic incorporations by sole proprietors. It would also be a very useful tool for an audit, as the returns would contain the information necessary to match reported income, at least once multiple years were examined.

C. Reporting of Sales on eBay and Other Online Auction Sites

"Yahoo, eBay, and other Internet auction sites allow millions of people to sell their products either as a hobby or as an actual business."⁶⁹ These sites do tremendous amounts of business; sales were projected to be \$48.5 billion for 2006.⁷⁰ "One industry spokesperson has estimated that more than 430,000 people generate most of their incomes selling on just the major Internet auction site."⁷¹

Given that many individual transactions involve small dollar amounts, enforcement is a difficult task for the IRS.⁷² Not surprisingly, many online sellers likely do not report their earnings from these sales to the IRS.⁷³ Yet, auction sites need to track the sales in order to collect their fees. For example, eBay typically charges the seller a fee for listing an item and an additional fee if the item sells.⁷⁴ In effect, eBay acts as a middleman or broker in the sales that occur on its site.

66. See *supra* note 54 and accompanying text (contribution of small businesses to the tax gap); *supra* note 60 and accompanying text (revenue estimates of proposal).

67. See *supra* note 56 and accompanying text.

68. J. COMM. ON TAXATION, 2009 BUDGET PROPOSAL, *supra* note 45, at 140–41.

69. Richard Malamud, *How the IRS Can Close the Online Auction Tax Gap*, 106 TAX NOTES 110, 110 (2005) (footnote omitted); see eBay, www.ebay.com (last visited Feb. 9, 2010); Yahoo! Shopping, <http://shopping.yahoo.com> (last visited Feb. 9, 2010).

70. Malamud, *supra* note 69, at 110–11.

71. *Id.* at 111.

72. Susan Albring, Lillian F. Mills & Marlene Plumlee, *Beanie Baby Billions? Unpaid Taxes on Internet Auctions*, 87 TAX NOTES 1153, 1158 (2000).

73. See *id.* at 1153 (estimating in 2000 "that uncollected capital gain taxes are in the hundreds of millions of dollars from eBay collectibles alone").

74. See eBay.com Fees, <http://pages.ebay.com/help/sell/fees.html> (last visited Feb. 9, 2010).

Brokers are required to file information returns.⁷⁵ The Code defines the term “broker” as “(A) a dealer, (B) a barter exchange, and (C) any other person who (for a consideration) regularly acts as a middleman with respect to property or services.”⁷⁶ The definition sounds like it could include sites such as eBay, which “regularly acts as a middleman” in numerous sales transactions.⁷⁷ However, Treasury regulations essentially limit the application of section 6045 to securities brokers.⁷⁸ In addition, the regulations provide that “[t]he following persons are not brokers . . . in the absence of additional facts that indicate the person is a broker: . . . A person (such as a stock exchange) that merely provides facilities in which others effect sales.”⁷⁹ Internet auction sites such as eBay arguably fall within this regulatory exception.⁸⁰

Before Congress enacted Code section 6050W, discussed below, there were several proposals to extend information reporting to online auction sites.⁸¹ One proposal, for example, was as follows:

75. I.R.C. § 6045(a) (2006). Note that “section 6041 . . . requires a business to file Form 1099 if it pays more than \$600 for services to one person during the year. Reporting is not required if the payment is for products. Because consignment and Internet sellers sell products rather than services, section 6041 doesn’t appear to apply to them.” Malamud, *supra* note 69, at 112 (footnote omitted).

76. I.R.C. § 6045(c)(1).

77. See Malamud, *supra* note 69, at 113 (concluding, after analysis, that “[i]t . . . appears that all the elements necessary to conclude that Internet middlem[en] and brick-and-mortar consignment sellers are brokers as defined in section 6045 are met and that accordingly, if ‘required by the Secretary,’ they must furnish a Form 1099 reporting the gross sales of their customers to the IRS”).

78. See *id.* (“According to the regulations, a business can be a broker only if it effects sales, and it effects sales only if what it sells are: securities, commodities, regulated futures contracts, or forward contracts for cash.”); see also Treas. Reg. § 1.6045-1(a)(1) (as amended in 2006) (defining broker to require “stand[ing] ready to effect sales to be made by others”); *id.* § 1.6045-1(a)(9) (“The term *sale* means any disposition of securities, commodities, regulated futures contracts, or forward contracts for cash, and includes redemptions of stock, retirements of indebtedness, and enterings into short sales.”).

79. Treas. Reg. § 1.6045-1(b) ex. 2(ii). In addition, the term “customer” is defined narrowly, generally requiring that, to be a customer, the broker must act as an agent for that person, as a principal, or as “[t]he participant in the sale responsible for paying to such person or crediting to such person’s account the gross proceeds on the sale.” *Id.* § 1.6045-1(a)(2)(iii). Internet auction sites do not always act in any of these capacities. See GENERAL EXPLANATIONS, *supra* note 35, at 65 (“[E]xisting law does not clearly impose the information return requirement on businesses that, with respect to sales of tangible personal property, may not be acting as agents of the customers (i.e., the sellers of the property).”). However, they sometimes collect the sales proceeds and remit them to the seller. See Malamud, *supra* note 69, at 114.

80. See Malamud, *supra* note 69, at 113 (“[T]he regulations define ‘brokers’ in such a restrictive manner that they do not include Internet auctioneers and traditional consignment sellers.”).

81. See, e.g., *Hearing on the Tax Gap*, *supra* note 33, at 14–15 (statement of Nina E. Olson); GENERAL EXPLANATIONS, *supra* note 35, at 65. Other countries have made specific requests to eBay for information about high-dollar sellers. See, e.g., Paul Waldie, *eBay Loses Bid To Shield Sellers from Taxman*, GLOBE AND MAIL (Canada), Apr. 29, 2008, at B1, available at <http://www.theglobeandmail.com/servlet/story/RTGAM.20080429.wrebay29/BNStory/Business/> (“The Federal Court of Appeal has upheld a lower court ruling and ordered eBay Canada Ltd. to comply with a request from the Canada Revenue Agency to

The requirement would apply only with respect to a customer for whom the broker has handled 100 or more separate transactions generating at least \$5,000 in gross proceeds in a year. There would be an exception from the proposed requirement (and the sale would not be taken into account for the 100 transactions/\$5,000 gross proceeds test) if the sale is required to be reported by other information return requirements (such as payment card sales the gross proceeds of which would be reported under the payment card reporting proposal). The IRS and Treasury Department would have regulatory authority to allow additional exceptions in appropriate situations in which the benefit of information reporting is outweighed by the cost of compliance.⁸²

Because, unlike securities brokers, auction sites typically will not know a customer's basis (because often they were not used to acquire the property), such information reporting would likely need to encompass only the gross proceeds. This is one reason why the proposal appropriately contains a threshold much higher than the \$600 threshold for reporting the services of independent contractors, for example.⁸³ Another, related, reason is that "[r]eporting personal rather than business sales could cause extensive reporting by taxpayers who are simply selling a few items from home, sort of as an online garage sale."⁸⁴ Moreover, "most items sold at a garage sale actually result in . . . personal, nondeductible losses."⁸⁵

As indicated above, Congress recently enacted Code section 6050W, which, in addition to requiring information reporting with respect to certain transactions by credit or debit card,⁸⁶ requires every "third party settlement organization,"⁸⁷ including auction sites such as eBay,⁸⁸ to issue an information report containing the name, address, and taxpayer identification number of each "participating payee"⁸⁹ who engaged in over two hundred

produce the names, addresses, phone numbers, e-mail addresses as well as gross sales figures for all Canadian PowerSellers. The PowerSeller program applies to people who sell at least \$1,000 (U.S.) a month through the site."); *The World Today: Online Sellers Targeted by Tax Office* (ABC radio broadcast Mar. 13, 2007), available at <http://www.abc.net.au/worldtoday/content/2007/s1870847.htm> ("[E]Bay is just one of a number of online auction sites being asked by the [Australian] tax office to provide details of sellers turning a profit of more than \$50,000 a year.").

82. GENERAL EXPLANATIONS, *supra* note 35, at 65. The proposal was estimated to raise \$1.97 billion from 2008–2017. *Id.*

83. See I.R.C. § 6041A(a)(2) (2006).

84. See Malamud, *supra* note 69, at 115 ("[A] good starting point might be mandatory reporting if there are more than 50 sales per year and at least \$2,000 of sales per year. Thus, a single car, even sold at \$15,000, would not require reporting and neither would 100 sales of CDs at \$11 each, unless both occurred in the same year.").

85. *Id.* A sale of an item for less than its basis results in a realized loss. See I.R.C. § 1001(a). A loss on the sale of a personal-use item generally is not recognized for tax purposes. See *id.* § 165(c).

86. This aspect of Code section 6050W is discussed below. See *infra* notes 103–24 and accompanying text.

87. I.R.C. § 6050W(b)(1)(B) (West Supp. 2009).

88. Jeremiah Coder, *Securities Basis Reporting Is a Step Toward Use of Technology*, 122 TAX NOTES 840, 841 (2009).

89. In general, a "participating payee" is "in the case of a payment card transaction, any person who accepts a payment card as payment, and . . . in the case of a third party network

transactions during the year if the payments aggregate over \$20,000.⁹⁰ The new law is scheduled to take effect on January 1, 2011.⁹¹

This new information reporting requirement has both benefits and drawbacks under the criteria provided above. On the plus side, it involves parties who are generally at arm's length. It also calls for entities such as eBay, not individuals, to make information reports, providing the advantage of centralization—one middleman would make reports to many sellers.

The principal disadvantage to this requirement under the above criteria is that these information reports will not—and cannot—provide all of the information necessary for the government to match the report with the amount on the taxpayer's return, because the reporting entity generally has no reliable way of knowing the taxpayer's basis in the property sold. The reporting requirement therefore essentially makes information reporting for sellers equivalent to what information reporting was for securities before the recent amendment requiring the inclusion of basis information.⁹² It will not provide for the easy matching that Form W-2 does with respect to employees' wages, for example, because an eBay seller's basis in the property sold would not be verifiable without an audit.⁹³

Another limitation of the proposal is that it will likely apply to relatively few sellers. Given that it applies only to sellers who have both more than two hundred transactions during the calendar year *and* receive in excess of \$20,000 of sales proceeds during that year, it generally will not apply to casual sellers. In addition, sellers who do a higher volume of business may be able to use self-help to limit the effectiveness of the reporting requirement. One ploy might be to divide up auction listings among multiple accounts, with some accounts registered in the name of the seller's spouse or children, so as to avoid the reporting threshold.⁹⁴ Another possibility would be to divide up sales among online auction sites, for the same reason. The inconvenience of learning multiple systems and tracking items on several sites should reduce but not eliminate the latter strategy.⁹⁵

transaction, any person who accepts payment from a third party settlement organization in settlement of such transaction," except that it will not include "any person with a foreign address" except as provided by the Secretary of the Treasury. I.R.C. § 6050W(d)(1).

90. *Id.* § 6050W(a), (e).

91. Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, § 3091(e)(1), 122 Stat. 2654, 2853 ("Except as otherwise provided in this subsection, the amendments made by this section shall apply to returns for calendar years beginning after December 31, 2010.").

92. *See supra* text accompanying notes 37–41.

93. This is also not a situation in which the payor generally can deduct the payments made, which would reduce the possibility of collusion. EBay purchases will often entail non-deductible personal or capital expenditures. *See* I.R.C. §§ 262, 263 (2006).

94. I am grateful to Kristen Fowler for suggesting this ploy.

95. Some sellers might also avoid auction sites and use venues such as garage sales, Craigslist, and the like. However, those venues are not close substitutes for auction sites, particularly for sellers with the volume of goods that will be subject to the requirement. Craigslist, <http://www.craigslist.org> (last visited Feb. 9, 2010), is not an auction site; it simply allows users to advertise items for sale. Craigslist would therefore not be subject to information reporting applicable to online auction sites. That makes sense because, unlike

In sum, this new law has its limitations, but it will likely increase compliance by some high-volume sellers,⁹⁶ particularly those who purchase their inventory online, because basis for those sellers is easier to track. If some of these sellers currently do not file tax returns, it might increase filing compliance, which could have positive spillover effects. On balance, particularly given its high threshold, this law holds some, though somewhat limited, promise.

D. Information Reporting in Consumer Transactions

As indicated above, one of the most difficult enforcement areas in the federal income tax relates to small businesses. Cash-based retailers have significant opportunities to evade taxation, and they thus pose a substantial enforcement problem. Several information reporting proposals have been floated that try to address this problem. This section discusses the prospect of information reporting (1) by consumers, and (2) by financial intermediaries, which Congress recently required, effective in 2011.

1. Reporting by Consumers

Professor Joshua Rosenberg has suggested the possibility that consumers file information returns on their retail purchases:

Perhaps the most obvious way to increase reporting of payments for consumer goods and services would simply be to require such reporting by the consumers. Because of the recordkeeping and other costs associated with reporting consumer purchases, even the most draconian reporting requirements would need to exclude some de minimis amounts. Of more importance, though, is the fact that merely “requiring” such reporting does not ensure that it will occur. Unless the reporter has some incentive to make the required report and/or some more realistic potential penalty for not making the report, simply requiring reporting is likely to do little.⁹⁷

As Professor Rosenberg’s discussion indicates, information reporting by consumers poses several problems. The six factors listed in Part I of this Essay⁹⁸ highlight several issues. First, cash retail transactions, although typically involving arm’s-length parties, pose the prospect of collusion, particularly given the fact that the consumer has little incentive to report the purchase. Note that the consumer is unlikely to be eligible for a deduction

eBay, Craigslist does not have a method for identifying when the seller has found a buyer for an item, and at what price.

96. IRS statistics show that items subject to partial information reporting have the rather high voluntary compliance rate of 91.4%. *See supra* note 19 and accompanying text.

97. Rosenberg, *supra* note 35, at 523–24 (footnotes omitted); *see also* Bankman, *supra* note 10, at 512 (“Greg Jenner has suggested we might extend the reporting requirements to consumers. . . . Greg Jenner’s suggestion was informal—an idea to be considered rather than a fleshed-out proposal.”).

98. *See supra* text accompanying notes 23–32.

for items purchased; personal expenditures generally are nondeductible.⁹⁹ Second, the proposal would require individual taxpayers, who generally lack a bookkeeping infrastructure, to issue the reports.¹⁰⁰ Third, the proposal would result in inefficient decentralization, as many consumers would be required to make reports on a single retailer.¹⁰¹ If the proposal were even partly effective, the IRS would therefore receive a high volume of reports on each retailer that it would need to process and aggregate. This proposal, therefore, is inefficient, and likely would not substantially increase compliance.

A creative alternative used in some countries is to have consumers' receipts double as lottery tickets.¹⁰² That gives consumers an incentive both to request a receipt and to report the transaction to the government. It removes much of the burden that information reporting would place on consumers, but does not overcome the disadvantage of decentralized reporting; it leaves the government with the burden of aggregating the receipts if it wishes to make use of them in the audit process.

2. Reporting by Financial Intermediaries in Consumer Transactions

An alternative to requiring reporting by consumers themselves is reporting by financial intermediaries—the banks who process purchases by credit card, debit card, and check. Recently enacted Code section 6050W, effective January 1, 2011,¹⁰³ which was discussed above in connection with

99. I.R.C. § 262 (2006).

100. See Bankman, *supra* note 10, at 512 (explaining that requiring consumers to report payment to service providers aggregating over \$600 in a single tax year “would in fact increase substantially the current record keeping burden associated with filing. There would often be many more items to report and the task of keeping track of each item would be more difficult”). There might be opposition for this reason:

In Australia, for example, consumers in the past were required to report payments made to contractors for home improvements that exceed \$10,000 (Australian).

That requirement, while seemingly quite modest and sensible, was dropped in face of consumer opposition, and the experience in administering that law has discouraged the government from adopting similar reporting obligations.

Id. at 509 (citing AUSTL. TAX OFFICE, THE CASH ECONOMY UNDER THE NEW TAX SYSTEM 31–32 (2003), available at <http://ctsi.anu.edu.au/publications/ATOpubs/cash%20economy.pdf>).

101. *Cf. Causes and Solutions*, *supra* note 46, at 4 (statement of Nina E. Olson) (“[R]equiring everyone making a taxable payment to file a report with the government would impose more burden than most of us would be willing to bear. No one wants to be obligated to file a document with the IRS every time he or she takes a cab ride, has someone mow their lawn, or calls a plumber to fix a broken faucet.”).

102. See, e.g., WORLD BANK, WORLD DEVELOPMENT REPORT 2005: A BETTER INVESTMENT CLIMATE FOR EVERYONE 110 (2005), available at http://siteresources.worldbank.org/INTWDR2005/Resources/complete_report.pdf

(describing such a program in China); Marla Dickerson, *Get Rich by Paying Taxes*, L.A. TIMES, Jan. 16, 2006, at A1 (mentioning similar programs in Chile and Costa Rica); Nirmal Sandhu, *A Lottery Lesson from Thailand*, TRIB. (India), May 19, 2003, <http://www.tribuneindia.com/2003/20030519/biz.htm#2> (“The government in Thailand now offers a handsome prize of \$7,000 each week to 11 winners, who scribble their names on the back of the receipts and send them to the Finance Ministry.”).

103. Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, § 3091(e), 122 Stat. 2654, 2911.

online auction sites, also requires every “payment settlement entity,” such as the bank that issued a credit card,¹⁰⁴ to issue information reports.¹⁰⁵ Those reports must contain the name, address, and taxpayer identification number of each payee to whom the entity makes one or more reportable payments (such as in settlement of credit card transactions),¹⁰⁶ as well as the gross amount of these payments.¹⁰⁷

The rationale for the new provision is as follows:

The Committee believes that requiring information reporting with respect to receipts from credit card and other electronic payment transactions will improve compliance and IRS enforcement efforts. Generally, business receipts that are subject to information reporting are less likely to be underreported by taxpayers. The Committee believes that expanding information reporting requirements will encourage the filing of timely and accurate income tax returns and improve overall tax administration.¹⁰⁸

Of course, reporting by payment card companies does not capture cash purchases.¹⁰⁹ The government could subsidize credit card purchases in order to encourage their use.¹¹⁰ However,

[m]erchants would have an incentive not to pass the subsidy on, and to otherwise discourage debit or credit card use—at least from those

104. I.R.C. § 6050W(b)(1), (2) (West Supp. 2009).

105. *Id.* § 6050W(a). The Treasury Department reported that “[s]everal commenters requested that the exception for de minimis payments [of 200 or fewer transactions during the year or \$20,000 or less in payments, applicable to third-party settlement organizations such as eBay] be extended to include payments in settlement of payment card transactions.” Information Reporting for Payments Made in Settlement of Payment Card and Third Party Network Transactions, 74 Fed. Reg. 61,294, 61,295 (Nov. 24, 2009) [hereinafter November 2009 Notice of Proposed Rulemaking], reprinted in 2009 TAX NOTES TODAY 224-10. However, “proposed regulations [issued on November 23, 2009] do not adopt this suggestion.” *Id.*

106. I.R.C. § 6050W(c).

107. *Id.* § 6050W(a). Consumers may raise privacy concerns about the new provision. However, because it calls for reporting of the aggregate amounts of payments to retailers—not customer-by-customer reporting (which is not needed to enforce the tax laws against the retailers)—privacy intrusions should be minimal.

108. HOUSE WAYS AND MEANS COMMITTEE REPORT ACCOMPANYING H.R. 6275, ALTERNATIVE MINIMUM TAX RELIEF ACT OF 2008, H.R. REP. NO. 110-728, at 35 (2008), available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_reports&docid=f:hr728.110.pdf. Treasury estimated the revenue of a similar proposal at \$10.7 million for 2008–2017. GENERAL EXPLANATIONS, *supra* note 35, at 66.

109. Professor Joshua Rosenberg made a proposal that included a requirement that large cash withdrawals be reported. See Rosenberg, *supra* note 35, at 524. However, it is not clear how those withdrawals would be matched with purchases by consumers from particular retailers.

110. See Bankman, *supra* note 10, at 510 (“South Korea and a number of Latin American countries including Argentina, Costa Rica, Columbia, Mexico and Uruguay have tried to reduce the cash economy by subsidizing credit and debit cards.”); Jasper Kim & Kemavit Bhangananda, *Money for Nothing, Your Crises for Free?: A Comparative Analysis of Consumer Credit Policies in Post-1997 South Korea and Thailand*, 17 PAC. RIM L. & POL’Y J. 1, 2 (2008) (reporting that a Korean “government initiative provided incentives for consumers to use credit cards, such as a twenty percent income tax deduction for those whose credit card expenditures totaled more than ten percent of his or her annual income”).

customers who might be expected to otherwise pay cash. The government might be left with paying the subsidy only with respect to electronic sales that would in any event have been reported for tax purposes.¹¹¹

A recent government report stated that “[s]ome merchants fail to report accurately their gross income, including income derived from payment card transactions.”¹¹² However, cash is likely a much larger problem, as it leaves little paper trail. Interview research by Professors Susan Morse, Stewart Karlinsky, and Joseph Bankman suggests that most credit card transactions are reported.¹¹³ Reporting of receipts from payment card transactions may help provide estimates of cash underreporting, however, by allowing the IRS to compare reported credit card receipts with the total amount reported.¹¹⁴ Currently, that requires an audit. However, to avoid or limit the amount reported, retailers could encourage the use of cash through cash discounts, as some already do.¹¹⁵

In theory, the statute raises the potential for duplicative reporting because it does not contain an exception for service providers.¹¹⁶ If they were included, that could result in duplication with existing reporting requirements.¹¹⁷ However, the statute gives the Treasury authority to issue “regulations or other guidance as may be necessary or appropriate to carry out this section, including rules to prevent the reporting of the same transaction more than once.”¹¹⁸ In proposed regulations issued in late 2009,

111. Bankman, *supra* note 10, at 510. In addition, one “obvious problem with subsidizing the use of credit and debit cards is that the poor, by and large, do not have either. Subsidization of credit card use would raise additional problems of overuse of credit.” *Id.*

112. GENERAL EXPLANATIONS, *supra* note 35, at 66.

113. See Susan Cleary Morse, Stewart Karlinsky & Joseph Bankman, *Cash Businesses and Tax Evasion*, 20 STAN. L. & POL’Y REV. 37, 50 (2009); see also Stewart Karlinsky & Joseph Bankman, *Developing a Theory of Cash Businesses’ Tax Evasion Behaviour and the Role of Their Tax Preparers*, in 5TH INTERNATIONAL CONFERENCE ON TAX ADMINISTRATION: CURRENT ISSUES AND FUTURE DEVELOPMENTS 136, 143 (Michael Walpole & Rodney Fisher eds., 2002).

114. See Morse et al., *supra* note 113, at 50–51.

115. See Karlinsky & Bankman, *supra* note 113, at 146 (“Someone in the insurance brokerage business who specialises in insuring contractors shared his experience that contractors will regularly give a 20% discount for cash”); *id.* at 144 (“One practitioner told us of a small business owner that opened his store unofficially on Saturdays for certain preferred clients and used a separate cash register. Merchandise was sold on a discounted basis for cash only.”); Morse et al., *supra* note 113, at 51 (“The tax preparers and businesspeople we spoke to in the jewelry and construction businesses . . . suggested that many jewelers and contractors offer a 20% discount for cash transactions.”). Nina Olson reports that “[c]ash and checks accounted for only 45 percent of payments in 2005, down from 57 percent in 2001.” TAXPAYER ADVOCATE SERV., 2007 ANNUAL REPORT, *supra* note 35, at 500. However, that is still nearly half of all payments. Moreover, retailers might increase the use of cash discounts once section 6050W becomes effective.

116. Cf. J. COMM. ON TAXATION, 2009 BUDGET PROPOSAL, *supra* note 45, at 147 (making this point regarding a proposed credit card reporting requirement).

117. Cf. *id.*

118. I.R.C. § 6050W(g) (West Supp. 2009).

the Treasury exercised this authority to provide relief from reporting under section 6041 for transactions also covered by section 6050W.¹¹⁹

This provision offers fewer efficiency disadvantages than the proposal for reporting by consumers, discussed above. Nonetheless, it is less than ideal under the six factors provided above. On the one hand, the possibility of collusion between banks and consumers is small. In addition, banks are businesses with a substantial bookkeeping infrastructure.¹²⁰ Using financial intermediaries as the reporting parties also centralizes reporting.

However, information reporting by financial intermediaries does not provide amounts that the government could simply match to amounts on taxpayers' returns. One useful change would be to require businesses to separately report amounts received via payment cards from amounts received by check or in cash.¹²¹ This would facilitate enforcement by making the comparison between cash and payment card receipts more obvious to both the IRS and the taxpayer.¹²²

Even in that case, however, the amounts reported by financial intermediaries often would not match the amounts reportable by businesses. Nina Olson points out, "gift cards and cash back transactions might make it difficult for the IRS to reliably match payment card data against amounts

119. See Prop. Treas. Reg. § 1.6041-1(a)(1)(iv), 74 Fed. Reg. 61,294, 61,301 (Nov. 24, 2009) ("Payment card transactions that are described in paragraph (a)(1)(ii) of this section that otherwise would be reportable under both sections 6041 and 6050W are reported under section 6050W and not section 6041."). In the Preamble to the proposed regulations under section 6050W, the Treasury Department mentioned several reasons why reporting of the same transaction multiple times could be beneficial, including that "the burden for reporting may fall on different persons." See November 2009 Notice of Proposed Rulemaking, *supra* note 105, at 19. However, the Treasury determined that duplicative reporting was not required in this context: "[F]or payment card transactions, relief from reporting under section 6041 is warranted because section 6050W reporting covers all payment card transactions and thus effectively encompasses all payments subject to section 6041 reporting made by payment card." *Id.* at 20.

120. The National Taxpayer Advocate recommended that "regulations . . . provide for a sufficiently prospective effective date to allow financial institutions to modify their reporting systems." TAXPAYER ADVOCATE SERV., 2007 ANNUAL REPORT, *supra* note 35, at 501. She also noted, "[f]inancial institutions that participate in the qualified payment card agent . . . program, which allows them to satisfy information reporting obligations for both the payee and payor, should have much less difficulty modifying their systems than other financial institutions." *Id.* at 501 n.54 (citing T.D. 9136, 69 Fed. Reg. 41,938 (July 13, 2004); Rev. Proc. 2004-42, 2004-2 C.B. 121).

121. Form 1120 currently calls for aggregate reporting of "[g]ross receipts or sales." IRS Form 1120, line 1a, available at <http://www.irs.gov/pub/irs-pdf/f1120.pdf>.

122. Cf. 1 TAXPAYER ADVOCATE SERV., 2009 ANNUAL REPORT TO CONGRESS 191, available at http://www.irs.gov/pub/irs-utl/1_09_tas_arc_vol_1_1_preface_toc_msp.pdf (proposing "[a]dding a line to Schedule C so that taxpayers separately report (1) the amount of income reported on Forms 1099 . . . and (2) other income not reported on Forms 1099"); Leslie Book, *The Need To Increase Preparer Responsibility, Visibility, and Competence*, in 2 TAXPAYER ADVOCATE SERV., 2008 ANNUAL REPORT TO CONGRESS 74, 85 n.50 (2008), available at http://www.irs.gov/pub/irs-utl/08_tas_arc_vol2.pdf ("Under the new provision, banks and other entities obligated to reimburse merchants using electronic payment card mechanisms will need to provide information returns to the IRS as well as the merchants. . . . This will allow a relatively easy determination of the percentage of gross receipts that reflect these reportable payments." (citations omitted)).

reported on returns.”¹²³ She suggests that the IRS could nonetheless use the information “to identify returns with a greater risk of noncompliance.”¹²⁴ This provision therefore has efficiency drawbacks similar to those associated with information returns for securities before basis was included. Most important, it does not get at the cash that is the core of the noncompliance problem for small businesses.

E. Requiring Gift Tax Reporting by Donees

Professors Mitchell Gans and Jay Soled have proposed requiring information reporting on taxable gifts:

Whenever a nonspousal donee receives a taxable gift (i.e., a gift that exceeds the gift tax annual exclusion or that does not qualify for medical or tuition exclusions), the donee would have to file an information return. Furthermore, if the donee receives multiple gifts from the same donor, the aggregate value of which during any calendar year exceeds the gift tax annual exclusion, the donee would likewise have to file an information return. The proposed information return would delineate the names of the donor and donee, a description of the property gifted including its tax basis, the date of the gift, and the fair market value of the gifted property.¹²⁵

Superficially, this proposal has some appeal. The gift tax is unusual in that if the party to the transaction who has the primary remittance obligation (in this context, the donor) does not remit the tax, the other party to the transaction (the donee) becomes liable for the tax.¹²⁶ In another context in which a transaction counterparty were secondarily liable for a tax, that likely would create an incentive for the counterparty to provide honest information reporting and thereby increase the odds that the primary obligor pays the tax.

However, on closer scrutiny, it becomes apparent that subjecting gifts to this kind of information reporting would be inefficient and ineffective. The donor/donee context necessarily involves parties who are not acting at arm's length. There is every incentive for parties who are close enough to give or receive a gift so substantial that it exceeds the annual exclusion under the gift tax¹²⁷ simply to collude in avoiding the tax (or conveniently remain ignorant of the obligation). In addition, donees are typically individuals who lack the bookkeeping infrastructure that businesses have.

123. TAXPAYER ADVOCATE SERV., 2007 ANNUAL REPORT, *supra* note 35, at 500.

124. *Id.*

125. Gans & Soled, *supra* note 36, at 793.

126. I.R.C. § 6324(b) (2006) (“If the tax is not paid when due, the donee of any gift shall be personally liable for such tax to the extent of the value of such gift.”). Remittance obligations for other federal taxes generally cannot be transferred to the other party to a transaction. *See* Logue & Slemrod, *supra* note 26, at 50.

127. For 2009, the annual exclusion is \$13,000 per donee from each donor. Rev. Proc. 2008-66, 2008-45 I.R.B. 1107 § 3.30. A married donor can obtain the consent of his or her spouse to give twice that much tax free. *See* I.R.C. § 2513(a).

Also, the ratio of donees to donors is close to one-to-one, so there is little efficiency gain in auditing donees rather than donors.¹²⁸

Additionally, the gift tax probably is not a major source of tax evasion. Its tax base is very small, in part because of sizable annual per-donee exemptions¹²⁹ and in part because of a lifetime per-donor exemption.¹³⁰ Gans and Soled note that the tax raises little revenue.¹³¹ Given its small tax base,¹³² that is probably not a sign that there is simply disproportionately large evasion of gift tax liabilities.¹³³

For all of these reasons, this proposal would provide little compliance benefit to the government if enacted. Moreover, given that the proposal would appear to increase governmental intrusion into family matters, it might be met with particularly vigorous opposition.¹³⁴ Professors Gans and Soled propose an alternative that does not pose these problems:

128. President Obama's fiscal year 2010 budget proposal contains an information reporting proposal targeted solely at consistency of valuation of noncash property transferred by gift or bequest. The proposal generally would require executors of estates and donors of gifts to report the value of the transferred property and would prohibit the recipient from claiming a higher basis in it (absent later adjustments). See FISCAL YEAR 2010 REVENUE PROPOSALS, *supra* note 15, at 119–20. Like the Gans/Soled suggestion, this proposal, which generally would apply to transfers by individuals to a similar number of transferees, does not fare well on the metrics of bookkeeping infrastructure and centralization. The estate and gift tax also is not a major contributor to the tax gap. See *infra* notes 129–33 and accompanying text. The parties also generally will not be acting at arm's length. However, the proposal may constrain inconsistent valuations for estates subject to estate tax. See, e.g., I.R.C. § 2010 (West Supp. 2009) (providing \$3.5 million credit against estate tax for 2009). Taxpayers have an incentive to claim a relatively low value in property for estate tax purposes in order to reduce the amount included in the gross estate, see I.R.C. § 2031(a) (2006), or to avoid subjecting the estate to tax at all. Heirs have an incentive to claim a higher value for income tax purposes because, under current law, basis in inherited property is the fair market value at death. See I.R.C. § 1014(a). Similarly, in the gift context, the donor will have an incentive to claim a lower valuation only if the gift exceeds the annual exclusion. See *supra* note 127. Donees have an incentive to claim a higher valuation only if the property has a value below its basis at the time of transfer and is subsequently sold at a loss. See I.R.C. § 1015(a); see also FISCAL YEAR 2010 REVENUE PROPOSALS, *supra* note 15, at 119.

129. See Gans & Soled, *supra* note 36, at 764–65 (noting numerous exclusions, including then-\$12,000 annual exclusion per donee from each donor); see also I.R.C. § 2503(b), (e) (providing exclusions from the gift tax).

130. See I.R.C. §§ 2010(c), 2505; see also Gans & Soled, *supra* note 36, at 763 (explaining unification with the estate tax, under which tax on lifetime gifts can be deferred). For taxpayers dying in 2009, the unified credit for estate and gift tax purposes is \$3.5 million. I.R.C. § 2010(c).

131. See Gans & Soled, *supra* note 36, at 760 (“For 2005, the last year for which there is available data, the gift tax raised approximately \$2 billion—considerably less than 0.1 percent of the overall revenue collected by the federal government for the same year” (citing INTERNAL REVENUE SERV., DATA BOOK 2005, at 1 (2006))).

132. See *id.* at 764–65 (noting that “the gift tax base is far narrower than one might anticipate”).

133. The gift tax serves in part to “protect the integrity of the estate tax” base. See *id.* at 761. The gift tax is not included in the IRS’s “Tax Gap Map.” See TAX YEAR 2001, *supra* note 10, at 1. The Tax Gap Map estimates estate tax underreporting at \$4 billion. *Id.* By contrast, it estimates underreporting of business income at \$109 billion. *Id.*

134. Gans and Soled recognize this concern but argue that it is overblown:

require taxpayers on their income tax returns (Form 1040s) to affirmatively answer the following yes-or-no question: During the course of the prior calendar year, did you make or receive gifts from another taxpayer that exceeded \$X (i.e., the annual gift tax exclusion) and that did not qualify for the medical and educational payment exclusions?¹³⁵

Although that would not entail third-party reporting, it would make the gift tax reporting requirement more salient. It would also require a donor who had made such a gift but preferred not to report it “to affirmatively lie,” not just to fail to file a return.¹³⁶

CONCLUSION

Asymmetric information underlies much of the difficulty the government faces in enforcing federal tax laws. The more information the IRS has about the taxpayer’s activities, the easier it is for it to enforce the law. And, since voluntary compliance is more efficient than enforced compliance, it is most important that the taxpayer know that the government has that information.

Information reporting is a well-known technique for increasing compliance, and it does so by reducing information asymmetries. Information reporting does not work equally well in all situations, however. This Essay provided a list of six factors for evaluating whether information reporting in a particular context is likely to be efficient. In general, the best candidates for information reporting are contexts in which a smaller group of businesses provides reports to a larger group of payees; those reports contain sufficient information for line-item matching with the taxpayer’s return; and the taxpayer has limited possibilities of substituting another behavior.

The framework proposed in this Essay suggests that the new basis reporting requirement for sales of securities will increase compliance but that the new requirements for information reporting by auction sites such as eBay and by financial intermediaries in consumer transactions may not substantially improve compliance. The framework also suggests that Congress should consider extending information reporting to payments to small corporate service providers. By contrast, it should not require individuals to issue information reports on consumer transactions or on gifts they receive.

Some commentators . . . would argue that this reporting requirement puts recipients in the uncomfortable position of having to “tattle” on donors. Put differently, does Congress really want to have taxpayers’ children (the recipients of most taxable gifts) serve as an enforcement arm of the IRS? Rejecting this reporting requirement as overly intrusive miscasts its essence, however, which is simply to check and confirm.

Gans & Soled, *supra* note 36, at 794.

135. *Id.* at 794–95.

136. *Id.* at 795.

Notes & Observations